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Article

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economic sociology_the european electronic newsletter

Provided in Cooperation with:

Max Planck Institute for the Study of Societies (MPIfG), Cologne

Suggested Citation: Mügge, Daniel (2010) : Amartya Sen's "The idea of justice" and financial regulation, economic sociology_the european electronic newsletter, ISSN 1871-3351, Max Planck Institute for the Study of Societies (MPIfG), Cologne, Vol. 12, Iss. 1, pp. 10-17

This Version is available at:

<https://hdl.handle.net/10419/155957>

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Amartya Sen's *The Idea of Justice* and Financial Regulation

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Introduction

Much political economy scholarship, including research showcased in this newsletter, has an implicit normative agenda. It sets out to uncover social structures that shape peoples' lives without their consent. More often than not, these social structures generate or sustain inequalities, whether in material welfare, exposure to risk, access to education or democratic participation, or the ability to lead lives in line with one's own norms and preferences.

Financialization is a hallmark of contemporary capitalism (e.g. Epstein 2005; Krippner 2005). Observers disagree about origins and consequences of the phenomenon and even its proper definition. For now, we simply take it to mean the growing relevance of processes in financial markets for structuring other economic or social domains. Financialization then highlights the reordering of production under ostensible pressure from unleashed capital markets (Froud, Haslam et al. 2000; Lazonick and O'Sullivan 2000; Duménil and Lévy 2004; Glyn 2006) as well as the changes these markets have wrought on peoples' everyday lives (Leyshon and Thrift 2007; Langley 2009; Warren 2010).

This prominence of finance has made it a common target of normative criticism. Analyses of how finance is regulated – even in fairly technical domains such as accounting standards (Perry and Nölke 2006) or capital adequacy rules (Claessens, Underhill et al. 2006) – have tried to uncover unfair or unjust(ified) consequences of the rules in question.

This work is often convincing in the analysis of regulation's consequences. But equally often it is sorely lacking clearly spelt out normative standards. At times, plain material inequality, tied to financial market functioning, is sufficient to elicit disapproval. Alternatively, rules that affect various stakeholders differently trigger claims that surely, financial regulation should be subjected to more democratic scruti-

ny than is commonly the case (Mügge, Blom et al. 2010; Mügge forthcoming).

Noble as such concerns, their advocates rarely offer concrete suggestions about the criteria financial regulation would have to fulfil to deserve our support. This is the point of departure for this article. Rather than starting from scratch, it climbs on the shoulders of a giant of contemporary political theory – Amartya Sen. His *The Idea of Justice* (Sen 2009) offers not only an accessible yet exhaustive overview of his own ideas; he also situates his arguments in broader debates in ethics, making comparisons with alternative formulations easy. An economist by training, Sen extensively draws on classics in political economy, including Smith, Marx and Mill, augmenting his relevance for debates over financial regulation.

Sen dismisses utopian approaches to justice, which try to sketch the just society. Instead, he favours enhancing justice incrementally. 'Enhancing justice' means identifying aspects of our social environment which can (and should) be changed if thereby people were empowered to live their lives in line with their own wishes. Sen recognizes that given diverging norms and preference orderings, it is impossible to reason through to the just society. Rather, deliberation is indispensable to understand how contrary demands on society can be reconciled in practice. Sen does not start from an objective vision of the good life, which people should (be entitled to) live. Instead, the key lies with people themselves. That said, he concedes that people are often deprived of meaningful control over their lives to such a degree that we can still identify their living situations as instances of grave injustices.

Convincing as the arguments are in their own right, it is not self-evident that they generate practical guidance when applied to financial regulation. While this article seeks to strengthen the foundations of normative debates about finance, it also explores the helpfulness of Sen's arguments for debates in finance in the first place.

Much of Sen's work has concentrated on developing countries (notably Sen 1999), and his approach that sees capabilities as freedom has relatively straightforward implica-

tions there. For example, scholarship drawing on Muhammad Yunus has spelled out how micro-finance might aid farmers and small entrepreneurs and insulate them against economic shocks (e.g. Young 2010). Normative imperatives here are relatively clear as credit is scarce and gross, and therefore easily identifiable, injustices abound.

In contrast, this paper concentrates on the OECD world. It explores to what degree well-established normative arguments are able to provide guidance in contemporary debates about financial reform. Three conclusions emerge from its analysis: first, publicly guided provision of credit has significant potential to advance societal justice. Framing debates around for example student loans or mortgages in terms of justice and empowerment (rather than for example economic investments) provides ammunition to those arguing in favour of heavy state intervention in this domain.

Second, the financial system could be made more just by curtailing the insecurity it inserts into people's lives. Financial innovation has often been hailed as an instrument to redistribute risk towards those actors willing and able to handle it. Arguably, the opposite effect has been at least as strong: by enticing corporations to plan short-term and pushing governments to deregulate labour markets, unleashed finance has increased many people's insecurity. This effect of liberalized finance offers much scope for corrective measures and the promotion of justice.

Finally, however, Sen's *Idea of Justice* is unable to guide reform of the plumbing of global finance – regulation covering wholesale finance including accounting standards, derivatives regulation, rules for credit rating agencies, etc. The effects of such rules are too complex and intertwined to allow an assessment of how their reform might boost people's capabilities. Instead, Sen's arguments suggest serious benefits from downscaling finance such as to allow meaningful political control. Given people's diverse preferences and values, the enhancement of justice as empowerment requires economic frameworks in which people can shape their financial environment through the democratic institutions that they (hopefully) have at their disposal. A return to some form of Bretton Woods-like order seems desirable – an order that combined openness to trade and regulated capital flows with at least the ambition to install democratic control over national financial systems. While the emergence of such an order may not be likely in the near future, the apparent difficulty to erect it is a crucial obstacle to the realization of justice.

Ethics and financial governance

Given the centrality of finance in people's lives there is surprisingly little debate about desirable financial system design that takes ethics serious. When Adair Turner, chairman of the British Financial Services Authority, suggested that we distinguish financial services that are 'socially useful' from those that are not, his statement was seen as ground-breaking.¹ From afar, of course, it is unclear what other than social utility we should consider when debating financial market policy. The furore surrounding Turner's statement was far more noteworthy than his 'insight' itself.

That said, four divergent perspectives reject an explicit consideration of ethics in financial regulation. First, thinkers of various hues deny that financial markets should be engineered with an eye to fairness standards of whichever kind. Libertarians see such tampering with markets as undue interference with individuals' inalienable right to use property as they see fit. This exclusive focus on individuals precludes an engagement with justice and fairness, both of which are relational concepts. Common as this position is, it completely ignores that – rather obvious for readers of this publication – finance is necessarily social. It is difficult to imagine a complex financial system that could function without some collectively binding rules. Hence, the notion that there existed something such as pre-social property or finance is absurd.

The second position trusts 'markets' to produce socially optimal outcomes. All that is necessary is to engineer proper market functioning – defined in narrow neoclassical terms – through regulation where necessary. All attempts to improve social welfare beyond this point are ultimately self-defeating.² Underlying this vision are several ideas: (1) market efficiency is possible, (2) it generates the highest aggregate material welfare, and (3) the latter is the ideal yardstick for measuring social utility. All three ideas are dubious, at best: the crisis has dampened what remained of the optimism about potential market efficiency, certainly in domains as complex as global finance. Once efficiency becomes elusive, arguments about its effects on aggregate growth ring hollow. As the crisis has hit the poor segments of societies disproportionately and exposed their vulnerability, it is unclear why the growth or decline of lower incomes should be treated similar to that of higher incomes, invalidating plain aggregation of material welfare. Finally, much theoretical and empirical work has demonstrated that material wealth narrowly-conceived is a poor guide to

people's happiness and the capacity to live the lives they want, certainly in the higher echelons of the income distribution. In short, a hands-off approach to financial markets in the name of market efficiency is indefensible.

Third, stability as a key goal of financial regulation has at times been elevated to the one overall objective to which financial regulation should contribute. Since the crisis, rules were re-evaluated mainly with an eye to their potentially destabilizing effects. As will be argued below, *ceteris paribus* such stability is also desirable from a justice as empowerment-perspective. But making stability the centre of reform efforts has setting policymakers setting their sights both too high and too low. On the one hand, financial stability, however difficult to achieve, leaves regulatory regimes underdetermined. Stable finance could take many shapes and colours, with widely divergent distributive effects. Facets of financial systems that have clear bearing on questions of justice would remain ignored. On the other hand, it is unclear whether financial stability can in fact be engineered. As Minsky (2008 [1986]) convincingly argued, stability inevitably creates complacency that sees policy makers and economic actors condone and indeed desire credit expansion lest economic growth is stifled. Booms and busts are the inevitable result. Investing all regulatory energy in ostracizing financial instability may thus be setting the aims too high and detract from other ways to enhance justice in the meantime.

The final argument in favour of ring-fencing markets against attempts to engineer specific outcomes is that market complexity dooms any such endeavours. This claim boils down to a distinction between markets, which can function well only when left to their own devices (with potential props to prevent market failure), and their non-market environment, including politics. Also this idea has been undermined from a variety of angles (Chavagneux 2001; Mitchell 2002; MacKenzie 2006). And the recent crisis has reinforced doubts that a self-contained financial system, which could be optimized according to its own 'inner' logic, could be distinguished. This is not to say that markets are 'trivial machines' in Herbert Simon's sense, which can simply be instructed to produce one or the other outcome (Simon 1962). Caution is clearly required, and our capabilities to bend financial markets to our own liking are seriously limited. This point holds for optimizing efficiency as much as for other political projects, however, so that it is no argument against at least the ambition to tailor financial market functioning to socially agreeable outcomes.

Once these four arguments against taking ethical considerations serious in financial market design are discarded, an explicit definition of what financial market policy is to achieve becomes necessary. Even the quest for financial stability is less straightforward than might be apparent right away. Clearly, stability advocates are not in favour of building a financial system so rigid that it would deprive most people of access to credit, just in the name of preventing crises and instability. Just where the proper mix between dynamism, entailing risks and potential disruption, and stability lies is a question for normative theorists to answer. His prominence in this field makes Sen a promising starting point for a search for answers.

Sen's Idea of Justice in a nutshell

Sen's idea of justice can most easily be sketched by contrasting it with those conceptions he rejects. His most fundamental distinction is between utopian ideas of justice and those that take the status quo as their point of departure. The former start by outlining the perfect society – whether in terms of material equality, opportunities for societal participation, or intellectual, personal and spiritual fulfilment.

Such utopias abound, but their champions rarely specify how they could be approached (indeed, whether that is possible at all) and how individual steps leading towards them should be evaluated on their own, given that we might 'get stuck' half way.³ Conceptions of justice – whether inspired by religious fundamentalism, radical liberalism or socialist or communitarian thought – often paint societal choices in stark terms: any society that is not just or 'right' is necessarily wrong. It is a question of all or nothing. In political economy, this problem emerges when we try to reconcile the realization that power relations penetrate capitalism to its core with the aim of human emancipation from domination. Does partial emancipation exist? Or are there just different degrees of subtlety? Engrossing as those questions may be, they inspire little guidance for policy-choices here and now.

Compared to the utopians, Sen takes a reformist and pragmatic position, going much further than his teacher John Rawls in *A Theory of Justice* (Rawls 2005 [1971]). Rawls had avoided a detailed sketch of the just society itself. But he did specify the rather demanding conditions under which humans might be able to agree on its contours. Absent these conditions, justice was necessarily out

of reach. Sen, in contrast, starts in the here and now. He accepts that people's preferences, norms and values may be incommensurable, whether as the result of socialization in different cultures or simply individual differences. We therefore cannot deduce what it is that people want; we can only go into the world and find out. Grand projects are eschewed in favour of incremental societal improvements.⁴

The diversity of norms and values makes plain material welfare inadmissible as the primary yardstick of societal improvement. Drawing on his earlier work (e.g. Sen 1999) as well as that of Martha Nussbaum, Sen instead opts for people's capabilities to attain their own goals as the anchor of his conception of justice. Furthering justice means changing society so that humans to gain control over their own lives in line with their preferences. It means creating choices where hitherto, there were none. His aim is thus not to define, let alone to create, *the* just society, but to outline a political ethic that seeks to empower people. Furthering justice means identifying and using our collective potential to make society more just than it is now.

What does all this mean for finance? What kind of financial reforms could empower people without unduly constraining others? Just what an 'undue' constraint on others is, is of course unclear. Extreme examples – a trade-off between one man's access to shelter and another man's third holiday home – may be easy to decide. Many other trade-offs are less clear-cut.

Sen sidesteps this question, which might otherwise dog his whole approach. First, there is nothing wrong with leaving thorny questions for later and dealing with straightforward ones first. Second, he acknowledges – more than most utopian philosophers – that people's perspectives differ, and that debate may change their mind, albeit in unpredictable ways. Justice is inevitably linked with public deliberation and some form of democratic decision making. It may thus be possible to craft sufficient consensus to remove at least some grave injustices – already a big step forward in its own right.

The contentious issues in finance and justice fall into three categories: the availability of credit to individuals, indirect effects of financial system functioning, and the aggregate effects of global financial system design (or the lack thereof). The following three sections will delve into each of these to establish whether Sen's thinking provides any guidance for policy.

Just credit?

The most immediate link between financial system functioning and justice as empowerment lies in the provision of credit. In developed countries, which are in focus here, credit is particularly relevant to finance the three key investments people commonly make in their life – education, a house to live in, and old age provision. Credit can of course not be supplied indiscriminately. To the degree that it is financed through government debt, well-meant credit provision can turn into an excessive burden for society as a whole. The key condition therefore is that credit schemes have to be sustainable, meaning that the burden they impose on future generations should not grow over time. The question is thus neither whether markets function efficiently, nor whether they boost long-term welfare by enabling profitable investment (a view commonly espoused with respect to education), but whether credit provision gives people relatively more control over their lives. Again, potentially adverse future consequences of present-day profligacy are part and parcel of this consideration.

Many OECD countries operate special credit arrangements for the domains mentioned: student loans and grants of various forms, mortgage regimes that target credit and the terms on which it is available to prospective house owners, and often highly intricate pension regimes. The existence of these regimes is good news from Sen's perspective. Government intervention to target credit signals the realization that credit availability is too important to citizens' lives to be left to the market alone. At least some of these credit-regimes have proven sustainable, meaning that they do not impose undue burdens on others, particularly on future generations through ever-mounting debt or excessive inflation for the assets that credit regimes target.⁵ Fine-tuning the credit supply to meet societal demands is thus possible and a worthy subject of public debate.

To be sure, in each of the domains mentioned above there is ample room for controversy and, from the perspective of justice as empowerment, room for improvement. For example, given scarce resources, it is unclear why tax breaks or concessional loans should be available to citizens who could follow their study of choice or build the home of their dreams without them.

While far from revolutionary, such a view on finance roots it firmly in the social dimension of the financial system. The perpetuation of societal inequalities in oppor-

tunity on the back of a skewed allocation of credit becomes indefensible.

Financialization and everyday life

The observable influence of financial system functioning on peoples' lives goes far beyond the distribution of credit. Consider three examples: the effects of corporate governance on employment, the impact of financial instability on life planning, and the distribution of micro-risks. All three centre on the same issue – relative stability of the economic context within which people can plan their lives.

In line with a general shift towards neo-liberal economic governance, corporate governance reforms in the industrialized world since the 1980s have emphasized the importance of corporations' flexibility. Maximum economic growth, so the argument, depends on the ability constantly to reconfigure the combination of production factors, crucially including labour – hence the call for the flexibilization of labour markets. The flexibility of the latter is primarily shaped by labour market legislation. But at the same time, a strengthening of corporate owners at the expense of workers has increased the emphasis on short-term profits and the attendant 'need for flexibility', particularly in economic downturns (Lazonick and O'Sullivan 2000, critically Froud, Haslam et al. 2000).

For many workers, the result has been clearly negative (Glyn 2006). Irrespective of ultimately unproven effects of flexibilization on aggregate employment, the insecurity that flexible labour markets introduce in workers' lives is at odds with the empowerment that Sen's theory of justice champions. Insecure work arrangements introduce anxiety in many peoples' lives and prohibit long-term planning. The potential need for periodic relocation can disrupt their social lives and generate an encompassing sense of rootlessness (Sennett 2007). If financial regulation triggers managers to push for internal flexibilization, justice could be advanced by providing employment conditions that give employees at least a modicum of control, the potential for long-term life planning and simply some peace of mind.

A similar argument centres on the deleterious effects of financial instability on such long-term planning. Even if in a liberalized economy the economic losses in downturns were compensated by additional economic growth during upswings, the disruptions such volatility introduces in people's everyday lives argue in favour of stability-

promoting financial regulation. Such regulation might require limiting financial innovation and its potentially beneficial economic effects. But moderate losses in trend growth would be balanced by the increased control stable economic conditions would grant people.

Finally, financial regulation at the retail end of the financial services food chain distributes the risks attached to financial transactions. Much customer protection legislation already attempts to insulate citizens from risks that they seem prone to misunderstand or unable to bear. That said, enshrining customer protection in financial regulation, often against resistance of the providers of financial services, has often been an uphill struggle, and frequently simply failed (e.g. Warren 2010).

Sen's approach bypasses legalistic arguments about where the responsibilities of customers begin and those of financial firms end. The real yardstick is much more practical: what works in the real world? Which way of organising finance would boost peoples' grip on their finances and lives most? This includes a curb on predatory lending and the strengthening of financial education so that people understand the products from which they can choose. Where products' complexity exceeds many peoples' ability to understand them, a justice as empowerment-approach suggests their prohibition. Why should citizens be exposed to risks that are designed to be incomprehensible? The freedom of the banker to sell products as he or she chooses weighs less heavily than the potential loss of freedom of people who get entrapped in impenetrable legalese and debt.

Justice and the nuts and bolts of global finance

Important as financial institutions and regulations that are close to citizens are, cross-border integration of financial markets means that all these unfold and are embedded in the strictures of global finance. To take one recent example, pensions, mortgages and student loans in Greece have probably been more affected by the eurozone turmoil in spring 2010 than by any specific Greek regulation. Global finance sets the boundaries in which national choices can be made. In this way, its regulation – particularly in wholesale capital markets – has a strong influence on peoples' capabilities, and it should therefore be a proper object for Sen's theory of justice. But does the latter have anything to say about how credit rating agencies, derivatives markets, accounting standards and the like should be transformed?

Alas, the link between regulation in any of these domains and humans' capabilities is too indirect to allow any such claims. Do we know how derivatives trading could be reformed to serve the aim of justice? Regulation in any one domain interacts with rules elsewhere, and – as the recent crisis has powerfully demonstrated – it remains difficult, if not impossible, to predict the real-world effects that regulation is likely to have. Also, justice for future generations prohibits opportunistic tampering with financial rules for example to boost consumption in the short term, only to invite an economic squeeze years down the line.⁶ In short, Sen is of no immediate help in reform efforts.

At the same time, his approach points to two more fundamental conclusions. First, if financial globalization inhibits country-level application of justice-standards to financial system design, the legitimacy of such globalization is seriously dented. Sen's perspective thus supports those who see financial globalization as a critical loss of national sovereignty. Most often, such arguments are advanced in the name of national economic development. The emphasis here is different: national control over financial markets may not only be necessary to boost aggregate economic development, but also to allow micro-level choices about ways in which financial system design can help people live the lives they want.

Second, then, global harmonization of regulatory standards is not necessarily desirable. Such harmonization normally advocated as a boost to market efficiency through the easing of cross-border flows and the emergence of best practices. From a perspective of justice, linked with scepticism about the existence of 'ideal' standards, such considerations do not trump the variegated effects of financial standards on peoples' capabilities. In short, financial regulation is not a case of 'one size fits all'.

Instead, empowerment would require meaningful political control and hence a set-up not unlike what Keynes had in mind at the Bretton Woods conference in 1944. It would require an open debate about financial de-globalization to promote such control. Intriguingly, in late 2009 the International Monetary Fund cautiously started to argue the case in favour of short term restrictions on capital inflows in emerging markets. In and of itself, this policy shift constitutes but a minor crack in the intellectual edifice of neo-liberal financial governance. But it does provide an opening that may yet lead to a wholesale reappraisal of the societal benefits of globally integrated finance and the ways in which it promotes or obstructs justice.

Conclusion

This paper has explored to what degree Amartya Sen's *Idea of Justice* can provide useful guidance for financial system design in general and financial regulation in particular. At the micro-level, his approach has clear potential: it provides a yardstick against which targeted credit provision can be evaluated. The key criterion, following Sen, is whether through custom-tailored credit regimes, we can boost people's ability to shape their lives in line with their preferences without shifting the burden for such gain on others. Similar perspectives can be usefully applied to more indirect aspects of financial system functioning, for example its effect on employment conditions.

Sen's thinking suggest also suggests the key constraint on reforming finance in this vein. The Pareto optimality that most economic theories of justice put central – welfare gains that do not disadvantage other members of society – appears too restrictive. It effectively locks in existing welfare levels and limits the scope for redistribution, not only of material welfare, but also of risk and opportunities in a more general sense. Once we consider extreme cases, such redistribution would clearly seem justified, for example when we contrast people living in opulence with those facing starvation. But a similar logic can be applied to less stark cases, and it holds for effects that financial systems have on peoples' lives just as much as for straightforward material redistribution. Justice in Sen's sense has to be more than just a progression of steps towards Pareto optimality.

Rather, the main constraint lies in the sustainability of financial arrangements. Any regime aiming to enhancing justice should not do so at the expense of future generations' abilities to operate a similar regime, for example because of excessive debts or credit-fuelled escalating asset prices. Justice has to be upheld also across generations.

Sen's approach is much less helpful as a guide for global regulatory reform in wholesale markets, largely because of the complexity of the financial system, our inability to link rule design directly to individual fortunes and unpredictable market behaviour. It does suggest, however, that global finance might need considerable downscaling and segmentation to bring it back under a kind of political control under which justice-related considerations could function as policy yardsticks. National financial systems would need to be insulated against potentially volatile global capital flows for justice in Sen's sense even to become possible.

Such de-globalization appears unlikely at this point. Indeed, officially the whole thrust of discussion, for example in the G20, centres on strengthening global governance in order to salvage cross-border financial integration. The aim is not to reinstall public choice, however, but to entrench the exigencies of global finance even more deeply (cf. Best 2003; Vestergaard 2009). Given the entrenched interests that stand to lose from a measured reinstatement of for example capital controls, this stance is hardly surprising. And there is little evidence that policymakers in charge of global finance spend much time poring over justice and how it could be enhanced through regulation. Pessimists would undoubtedly attribute this state of affairs to the presumed egotism of economic actors. But maybe we simply have failed to spell out clearly just what it would mean for regulatory reform if justice were taken seriously. In that case, the onus is on scholars of finance who do see room for normative considerations in financial governance to explicate and think through their own standards of ethical judgement.

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Endnotes

1See the interview with Turner in the August 2009 issue with Prospect Magazine.

2Think, in a different context, about arguments that trying to increase employment through deficit spending will only spur inflation in the long run.

3Consider the building of communist society. All attempts to create such a society have stalled way short of their ultimate goal, often installing authoritarian and repressive political systems along the way. Irrespective of one's support for communist ideals, such effects of their implementation should figure in our normative assessment of these ideals. See von Hayek's arguments against socialism in *The Road to Serfdom* (von Hayek 2001 [1944]) and related arguments by Popper in *The Open Society and Its Enemies* (Popper 2003 [1945]).

4Here his arguments again chime with Popper, but also with skepticism of modernist top-down reform as articulated for example by Scott (1998).

5This is a particular worry in real estate markets, in which blanket tax rebates for mortgages, for example, arguably end up in the pockets of current house owners through increased real estate prices – an effect that is largely a consequence of limited short-term supply of housing.

6Think for example of calls on rating agencies to be more lenient towards sovereign governments in the eurozone. The effect would undoubtedly be a further build-up of debt, with dire consequences in the future.

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